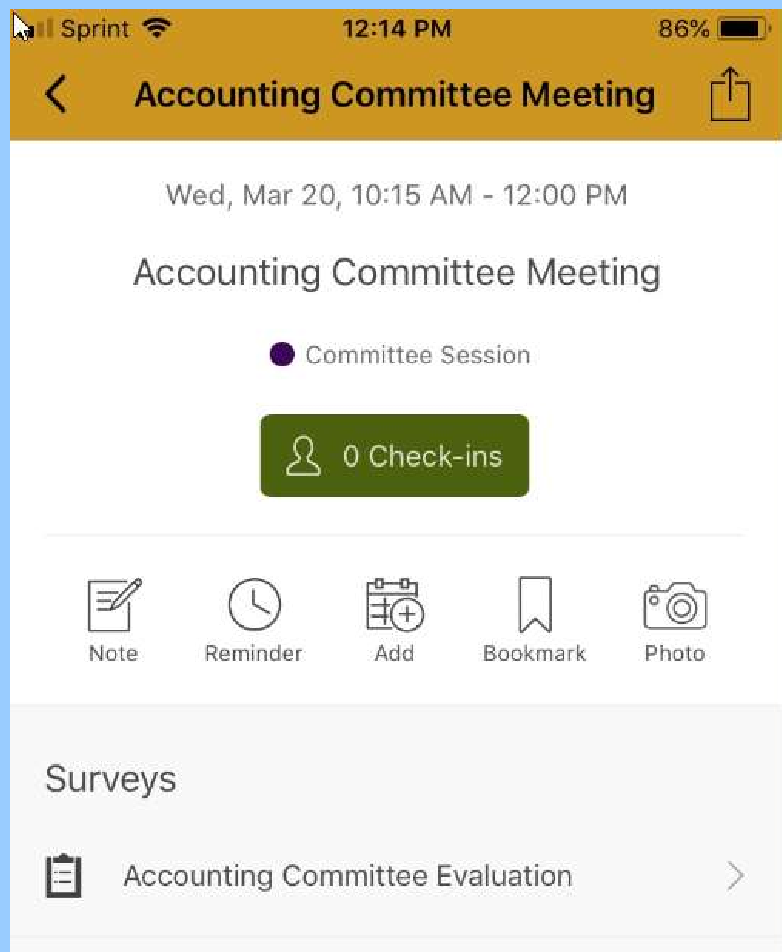
Accounting Committee



Accounting Committee

NCREIF Summer Conference

Washington, DC

June 19-20, 2019

Accounting Committee Agenda

Wednesday, June 19th

2:30 to 2:45	- Welcome and Chairpersons' Intro - Committee Members' Intro - House rules/Objectives of Committee - Survey App instruction
2:45 to 3:00	- Survey Results & Recap of Phoenix (Winter Conference)
3:00 to 3:15	- Solutions Expo – Phoenix 2020 - Accounting FV Manual Volunteers
3:15 to 4:00	Networking
4:15 to 5:30	Hot Topics
6:00 to 10:00	Capitol Steps followed by Moonlight Tour

Accounting Committee Agenda

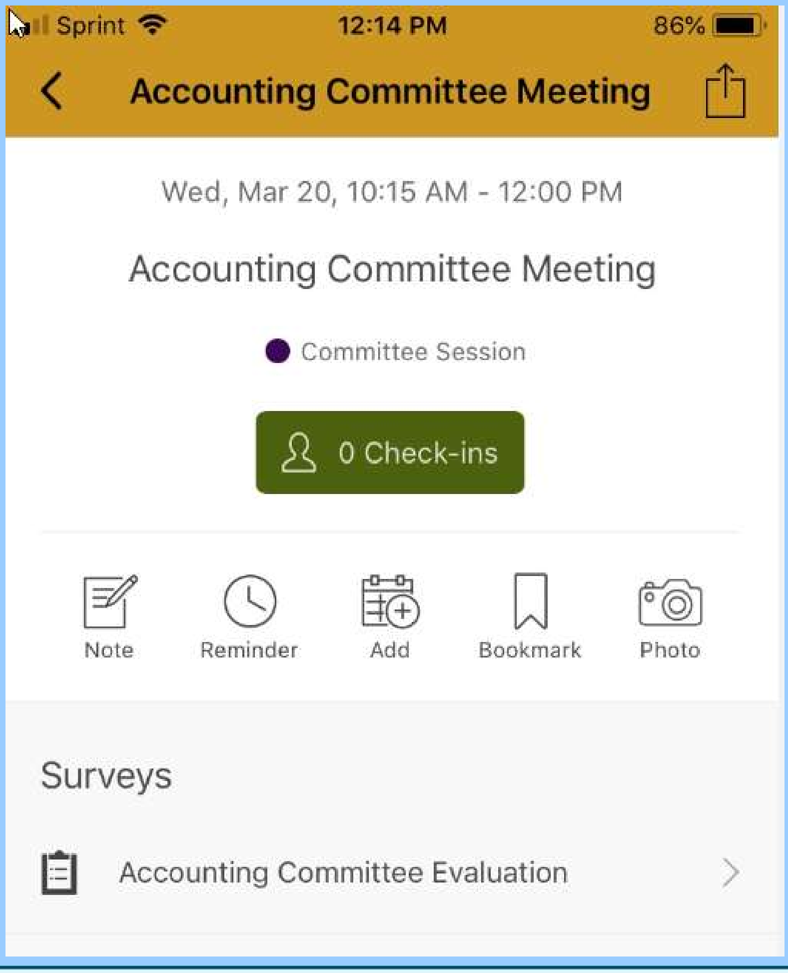
Thursday, June 20th

8:30 to 10:00	Reporting Standards 2020 or
	Tech Series: Investment Analysis with AI
10:15 to 11:45	General Session: Debt Bubble and More
12:00 to 1:30	Luncheon
10:45 to 11:00	Break
1:45 to 3:15	Financial Technical Update: PwC
3:45 to 5:00	CRE Investment Outlook or
	Opportunity Zones 101 and Then Some
5:00 to 9:30	Closing Evening Reception

Accounting Committee

- Chair Introductions/Background
  - Benay Kirk, Alter Domus
  - Eric Mack, USAA Real Estate
  - Robert Fraher, KPMG
  - Hunt Holsomback, Alvarez & Marsal

Accounting Committee



NCREIF

Accounting Committee

- Committee Introductions

- House Rules
  - Sign-In
  - General Objectives of the Accounting Committee
  - Surveys

- Survey App Instructions

Survey Results from Phoenix

- On a scale of 1-10, overall rating for all sessions was 9.0.
- Top rating was the Hot Topics – 9.3
- Technical Update (9.2), Reporting Standards (9.1) and Carried Interests (9.1) also received high ratings.
- Recap/Summary (8.7) and House Keeping/Ground Lease (8.4).
- We continue to receive both positive and constructive feedback and suggestions that helps us for future conferences. Keep'em coming - Your input is valuable!

Re-Cap from Phoenix

- Survey/Recap/AICPA Guidelines
- Ground Lease and Unit of Account Update
- Networking
- Hot Topics
- Reporting Standards
- Technical Update
- Incentive Fees / Promotes – Breakout Session

House Keeping

- Solutions Exp – Phoenix 2020
  - As evidenced by recent committee agendas and initiatives, members are clamoring for solutions to business challenges, i.e., Performance Dashboards, Argus Enterprise training, Investment Technology for Investors, Outsourcing.
  - To facilitate education around solutions, NCREIF proposes hosting Solutions Expo, and inviting Providers to present their platforms and services to our membership.
  - Providers will be welcome by Invitation Only.
  - Invitees will be sourced by committees. We have been asked to spend time discussing best practices, platforms of interest, (particularly from member providers), in order to provide NCREIF with a desired invitee list from our committee.

- Accounting FV Manual – Volunteers?
  - The Fair Value Accounting Policy within the NCREIF PREA Reporting Standards is reviewed on an annual basis and is approved at the NCREIF Fall Conference by the Accounting Committee. A task will be formed and led by Eric Mack and we will have 5-6 calls over the next few months. The purpose of the annual review is to ensure that it is up to date including any new ASU's, additions, etc.

Networking

- Solutions Expo
  - Recommended “Solutions” to include?

  - Other thoughts?

  - As evidenced by recent committee agendas and initiatives, members are clamoring for solutions to business challenges, i.e., Performance Dashboards, Argus Enterprise training, Investment Technology for Investors, Outsourcing.
  - To facilitate education around solutions, NCREIF proposes hosting Solutions Expo, and inviting Providers to present their platforms and services to our membership.
  - Providers will be welcome by Invitation Only.
  - Invitees will be sourced by committees. We have been asked to spend time discussing best practices, platforms of interest, (particularly from member providers), in order to provide NCREIF with a desired invitee list from our committee.

Hot Topics / Best Practices

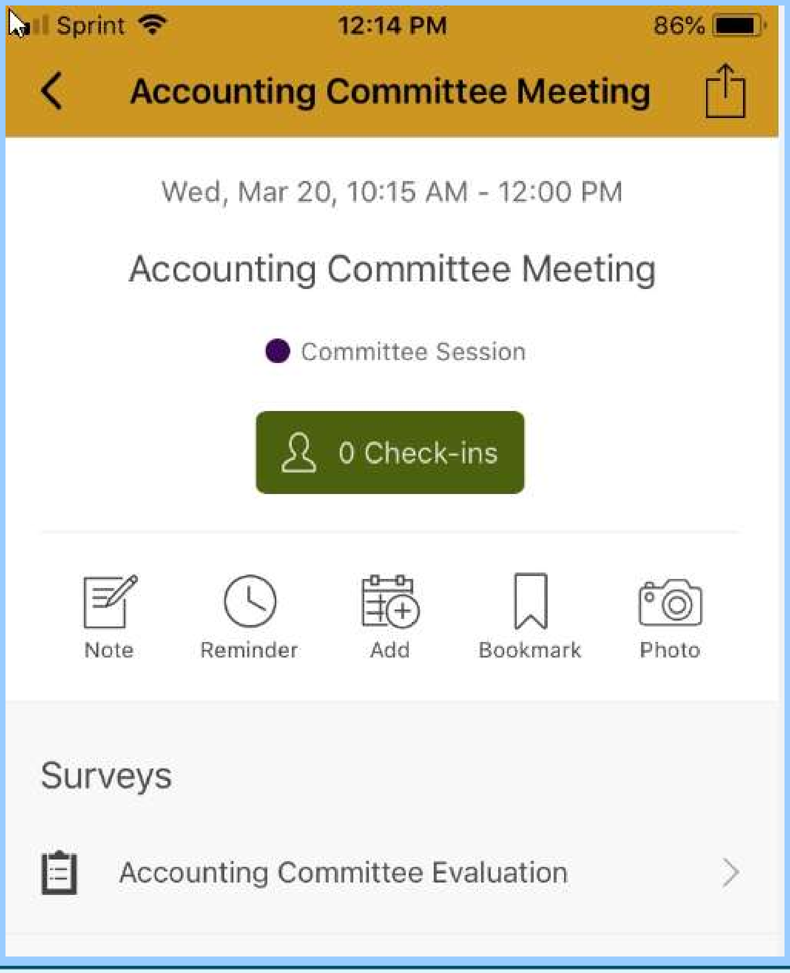
- Valuation Standards Exposure Draft – John Kjelstrom to give an update
- Any experience implementing robotics for accounting?
- Practice for expensing of financing costs.
- Ground Lease – some thoughts from an early implementation of a disclosure only approach
- Any experience using surprise exams to satisfy RIA custody rules?
- Level of interest in a European RE focused session in future conference.
- Proposed Fund Administration survey update
- Investor Reporting Solutions and if/how are we are using the systems for ILPA compliance.
- Standalone Joint Venture Audits – Historical Cost or Fair Value?
- Logistics working with JV Partners – Accounting/Reporting
- Treatment of "incremental" leasing costs under new leasing standard
- Capital Statements for Open Ended Funds vs. Closed Ended Funds

Accounting Committee Agenda

Thursday, June 20th

8:30 to 10:00	Reporting Standards 2020 or
	Tech Series: Investment Analysis with AI
10:15 to 11:45	General Session: Debt Bubble and More
12:00 to 1:30	Luncheon
10:45 to 11:00	Break
1:45 to 3:15	Financial Technical Update: PwC
3:45 to 5:00	CRE Investment Outlook or
	Opportunity Zones 101 and Then Some
5:00 to 9:30	Closing Evening Reception

Accounting Committee



NCREIF accounting discussion and recent trends

June 20, 2019

pwc

Table of contents

Management company accounting

How the revenue standard impacts the real estate industry

Overall impact of the standard

Impacts: Real Estate asset managers will recognize revenue they expect to be entitled to in exchange for services, subject to a ‘constraint’

Key Steps

1	**Identify the contract(s) with a customer**
2	**Identify the performance obligations in the contract**
3	**Determine the transaction price**
4	**Allocate the transaction price to the performance obligations in the contract**
5	**Recognize revenue when (or as) the entity satisfies a performance obligation**

Impact of standard will vary based on the structure and investments of an entity

Constraints limit the amount of consideration that may be currently recognized to that which is probable that a significant reversal in the amount of cumulative revenue recognized will not occur

1. Identify the contract(s) with a customer

- Identifying the customer (i.e. the fund or the investor) has ramifications throughout the revenue model and might significantly affect how the stand is applied
- Management will need to weigh different factors and make a conclusion based on facts and circumstances of the overall relationship

Fund

- Large Number of Investors
- Fund can enter into contracts with third parties for additional services (i.e. fund accounting or transfer agent)

Investor

- Few Investors
- Investors involved in structuring investment vehicle (negotiating specific fees, tax structure, etc)
- Investor involved in selection of fund strategy

Other considerations – Contract costs

Real estate asset managers should consider if placement fees, capital raise commissions, and other significant upfront transition costs to onboard new customers are costs incurred to obtain or fulfill a contract with a customer and therefore should be capitalized. Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (e.g., sales commissions). Under the new revenue standard, an entity is required to recognize an asset for the incremental costs to obtain a contract that management expects to recover.

Requirements for Capitalization

- The costs relate directly to a new contract,
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and
- The costs are expected to be recovered

If costs to obtain a contract are in the scope of another standard (e.g., inventory, fixed assets, intangibles) managers should capitalize or expense these costs based on the guidance in those standards

Illustration – Impact of identifying customer

- Investor purchases investment via subscription in an open ended fund
- Fund has been in operation for several years and has other investors
- Investment manager pays a fee to a third-party placement agent for successful placement of new investor
- Investor plays active role in structuring its investment for tax purposes, negotiating the management fee and provides input into what investments can be acquired with its capital

Is the investor or fund the customer?

Illustration – Impact of identifying customer (continued)

- Investor purchases investment via subscription in an open ended fund
- Fund has been in operation for several years and has other investors
- Investment manager pays a fee to a third-party placement agent for successful placement of new investor
- Investor plays active role in structuring its investment for tax purposes, negotiating the management fee and provides input into what investments can be acquired with its capital

Is the investor or fund the customer?

In this example the investor is the customer and the placement fee can be capitalized and amortized over the term of the contract (i.e. subscription agreement) with the investor, which would represent the minimum required hold period (lockup period). If the fund had been deemed the customer, the placement fee would have been expensed as incurred because it would not represent a cost to obtain or fulfill a contract with a customer as the fund is already in operations and the fulfilment period is over.

2. Identify the performance obligations in the contract

- It is important to correctly identify individual performance obligations
- Having more than one performance obligation in a contract could impact the timing of revenue recognition as different performance obligations may be satisfied as different times
- Contracts with several different performance obligations are common in the real estate asset management industry.

Performance obligation: A promise in a contract with a customer to transfer...a service or a series of distinct services that are substantially the same...

Identification of performance obligation is from the perspective of the customer

2. Identify the performance obligations in the contract (continued)

What constitutes an agreement

- Even though services and fees may be included in different contracts, they could still represent a single performance obligation
- The new standard requires a company to combine contracts with the same customer entered into near or at the same time if:
  - They are negotiated as a package
  - The amount of consideration in one contract depends on the price or performance of the other contract
  - The service in the contract represents a single performance obligation
- For real estate asset managements, contracts entered into at the start of a fund are often viewed as single arrangements.

What is a distinct service?

- A service is distinct if:
  - The customer can benefit from the service on its own or together with other resources readily available to the customer
  - The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract
- If a service is not distinct, the entity must combine the service until the point when a bundle of services are viewed as distinct
- A service which is regularly sold by itself is an indication that a customer can benefit from the service on its own or with readily available resources

Illustration – Identifying distinct services

- An asset manager sets up a new fund and the fund is determined to be the customer
- The management agreement and other contracts entered into at the same time provide asset management and distribution (syndication) services to the fund
- The manager often provides distribution services without providing other management services to other customers

Is the distribution (syndication) agreement a distinct service?

Illustration – Identifying distinct services (continued)

- An asset manager sets up a new fund and the fund is determined to be the customer
- The management agreement and other contracts entered into at the same time provide asset management and distribution (syndication) services to the fund
- The manager often provides distribution services without providing other management services to other customers

Is the distribution (syndication) agreement a distinct service?

Yes - The fact that the manager often provides distribution services without other management services indicates that these services are capable of being distinct and therefore the asset manager would likely conclude that the distribution service is separately identifiable based on the fact that (1) asset managers typically do not provide a significant service of integrating the distribution service with other services promised in the contract into a bundle of services that represent the combined output for which the customer has contracted, (2) the various services do not significantly modify or customize one another, and (3) the services are not highly interdependent or highly interrelated because the asset manager would be able to fulfil each of its promises independent of the others.

2. Identify the performance obligations in the contract

- Revenue recognition will also depend on whether the real estate asset manager's promise meets the criteria to be accounted for as a series
- Per ASC 606 most asset management services are considered a series of distinct services
- A series of distinct services provided over time is accounted for as a single performance obligation

Series: promise to transfer a series of services that are substantially the same and that have the same pattern of transfer to the customer over time

Illustration of principal:

On a closed-end real estate fund, a real estate asset manager provides fund management services. In consideration for its services, the asset manager earns a base management fee of 1.5% of AUM and a performance-based incentive fee of 20% of the fund's returns in excess of a 10% IRR at the end of the fund's life. If the real estate asset manager determines that the series guidance applies, it would record the base management fee at the end of the month because the uncertainty (i.e., the fund's AUM), has resolved itself and the fee earned is associated with the distinct services provided over the month. However, the real estate asset manager may conclude it is not appropriate to record any of the performance-based incentive fee because it is not probable that a significant reversal of the cumulative revenue recognized will not occur when the uncertainty (i.e., the actual IRR at the end of the fund's life) is resolved.

3. Determine the transaction price

- Management must determine the amount of the transaction price at contract inception and each reporting date
- The transaction price should consider all potential adjustments to contract consideration such as fee waivers and other concessions
- If the amount the asset manager expects to be entitled to is variable, consideration included in the transaction price is limited to the amount to which a significant reversal is not probable
- Management will need to determine if there is a portion of the variable consideration (i.e., some minimum amount) that should be included in the transaction price, even if the estimate of the entire variable consideration is not included due to the constraint

Transaction Price: consideration the asset manager expects to be entitled to in exchange for satisfying its performance obligations

The transaction price will determine the amount of revenue to be recognized at any point in time over the contract term

4. Allocate the transaction price to the performance obligations in the contract

- ASC 606 requires allocation of the transaction price based on the relative standalone selling price
- For most asset management agreements we believe the contractual price is often reflective of standalone selling price
  - Preparers should be on the lookout for off market or uneconomical terms

Standalone Selling Price: The price at which an entity would sell a promised good or service separately to a customer

5. Recognize revenue when (or as) the entity satisfies a performance obligation

Management Fees

New Standard	Prior GAAP
A fixed percentage asset-based management fee is considered a type of variable consideration that is subject to the constraint. For management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will be resolved as of the end of each reporting period. The asset manager will attribute the revenue from management fees to the services provided during the period because the fees relate specifically to the entity's services for that period.	A fixed percentage asset-based management fee is earned for providing asset management services. These fees are generally recognized as revenue each period in accordance with the terms of the asset management contract.

Potential Impact: In general, the accounting for management fees that are based on current assets under management and are not subject to clawback is not expected to change.

5. Recognize revenue when (or as) the entity satisfies a performance obligation (continued)

Performance Fee

New Standard

Return-based performance fees are also considered variable consideration. The real estate asset manager should recognize revenue only if, after an assessment of the facts and circumstances, it is probable the amount of variable consideration would not result in a significant reversal of cumulative revenue recognized. Performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. The manager should consider if there is some minimum amount which should be recognized.

Prior GAAP

Performance fees based on a formula that are tied to returns subject to performance targets (i.e., high watermark) may be recognized using one of two methods:

Method 1, recognized in the periods during which the related services are performed and all the contingencies have been resolved (typically upon termination of the fund or when distributions from a fund exceed the clawback)

Method 2, recognized as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date

Potential Impact: May result in significant changes for entities that recorded performance fee revenue under Method 2, given the new guidance requires a higher degree of certainty regarding the amount of the performance fee before revenue can be recognized. Those applying Method 1 will need to consider whether a minimum amount of consideration should be recognized at an earlier point in time.

Expected impact on revenue recognition

Other Performance Fee Considerations

Equity Investments

The FASB has expressed that it was the Board's intention that the new guidance would cover incentive-based capital allocations; it believes ASC 606 addresses asset manager service contracts regardless of whether the fee is paid in cash or a capital allocation. It is the FASB's view that the fees are designed to compensate the manager for services performed. However, the SEC staff did not object to the conclusion in certain asset manager fact patterns that partnership investment (inclusive of the carried interest) could be accounted for in accordance with ASC 323, **Investments - Equity Method and Joint Ventures.** This would only be appropriate if the asset manager receives their compensation in the form of a carried interest or capital allocation and the manager would not be required to consolidate the investment under ASC 810.

Impact

The SEC staff also did not object to the conclusion that the hypothetical liquidation at book value ("HLBV") method would be an acceptable method in applying ASC 323 for the asset manager's ownership interest and carried interest. The HLBV method involves assuming that the assets of the fund are distributed to the investors at the reporting date based on their current carrying value. If the fund applies specialized industry guidance, its assets may be reported at fair value. In these cases, the result of applying the HLBV method may be similar to the effects of applying Method 2 under prior GAAP. For existing investments which were previously accounted for under ASC 605 this would be considered a change in accounting policy. **Robust disclosures regarding the use of this method would be expected.**

Other considerations – Construction and development management agreements

Real estate entities may provide development management services to their customers. The structure of compensation for these services will vary between contracts. For example, one developer may be compensated based on the percentage of completion of the underlying development (using costs incurred), while another could earn its fee based on milestones (e.g., 30% upon the completion of pre-development and 70% upon completion of the development).

New Standard

The arrangement is required to be recognized over time (i.e., over the development or project period) if the development project receives the benefit of the development services over time, which is often the case. The developer must select an attribution method (an input or an output method) that should be used to recognize revenue that is most reflective of the pattern of transfer of services to the customer. A single attribution method should be applied to each distinct performance obligation.

Prior GAAP

Fees earned by a developer or project manager were often recorded in revenue based on contractual terms (e.g., completion of development or achieving milestones).

Timing and measurement of revenue recognition for real estate developers utilizing a percentage of completion method under prior guidance would generally remain the same

Other considerations – Leasing commission revenue

Asset managers often provide leasing brokerage services on behalf of third parties or related parties. In certain scenarios, the associated commission may be earned per the terms of the contract partially at the inception of the lease with the remaining portion earned upon satisfaction of some future contingency. If the broker believes it has substantially satisfied its performance obligation at a point in time (e.g., lease inception) and collection of the second half of the lease commission is probable and not subject to significant reversal, then such amount would be recorded earlier under the new revenue standard.

Example

A real estate entity brokers a third-party leasing arrangement in which the tenant will pay an aggregate of $10 million in rent for an initial period of ten years. The real estate entity receives a commission of $600,000 (6% of $10 million), payable in two installments per the terms of the contract. The first installment (50%) is earned and payable upon successful execution of the lease. The second installment is earned and payable upon tenant move in and payment of the first month’s rent. The real estate entity's comparable historical experience supports it is probable the tenant will move in and pay their first month’s rent.

When should the asset manager record revenue for the leasing commission?

Other considerations – Leasing commission revenue (continued)

When should the asset manager record revenue for the leasing commission?

New Standard

There is likely a single performance obligation that is satisfied when the tenant signs the lease, assuming the broker is not obligated to provide any substantive services subsequent to lease inception. The portion of the transaction price associated with the tenant move in and payment of first month's rent is a form of variable consideration, since the second half of the commission is contingent upon the two events occurring. An estimate of variable consideration is included in the transaction price and recognized as revenue if the entity concludes it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur (i.e., the real estate entity would record the entire $600,000 commission when the tenant signs the lease).

Prior GAAP

The manager has recorded the commission to revenue based on the contractual earning terms (e.g., 50% upon signing of the lease and 50% upon tenant move in and payment of the first month's rent).

Other Considerations – Contracts with more than two parties

Real estate managers often enter into contracts to provide other services to customers (property management, facilities management, project management, etc). The manager may (1) self perform the service using its own employees, 2) subcontract portions of the services to third-parties, or (3) oversee and manage third-party subcontractors and vendors who have existing contracts directly with the property owner or occupier.

When a third party is used to provide these services the property manager must determine if it is acting as the **principal** or **agent**. This determination, which is a control based model, will have consequences consideration is recorded in their financial statements.

Principal v agent evaluation should be performed for each performance obligation in the agrangement

Indicators of Principal

- The entity has responsibility for fulfilling the promise to provide the specified service
- The entity obtains or commits to obtain the specified service before obtaining a contract with a customer, and
- The entity has discretion in establishing the price for the specified service.

Example 1 – Contracts with more than two parties

Background: A real estate service provider supplies property management services to a real estate venture for a fee. The service provider's work is partially performed by its own employees and partially performed by subcontractors (e.g., electric work, lawn maintenance). The real estate service provider is not a party to the sub-contractor contracts, as the real estate venture negotiates the pricing and the services with the third-party subcontractors directly. The service provider is also not responsible for the work performed by the subcontractors. It is, however, responsible for the overall management of the property.

Question: With regard to the services provided by the service provider's employees and the third-party subcontractors, is the real estate services provider the principal for the services performed?

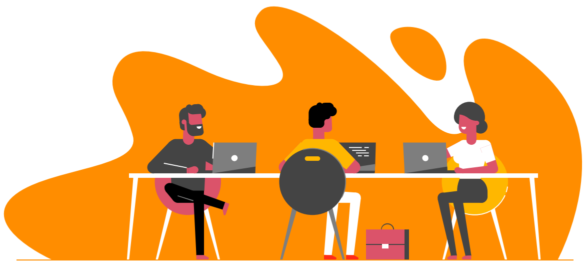
Example 1 – Contracts with more than two parties (continued)

Background: A real estate service provider supplies property management services to a real estate venture for a fee. The service provider's work is partially performed by its own employees and partially performed by subcontractors (e.g., electric work, lawn maintenance). The real estate service provider is not a party to the sub-contractor contracts, as the real estate venture negotiates the pricing and the services with the third-party subcontractors directly. The service provider is also not responsible for the work performed by the subcontractors. It is, however, responsible for the overall management
of the property.

Question: With regard to the services provided by the service provider's employees and the third-party subcontractors, is the real estate services provider the principal for the services performed?

Discussion

The real estate service provider is the principal for the services provided by its employees but not for the work provided by the subcontractors, even though the service provider is responsible for the overall property management. The real estate services provider does not have (1) performance risk for the subcontractors' work, as the third party is directly responsible to the real estate venture for its performance, (2) pricing risk, as the price charged by the third-party subcontractors is negotiated by the real estate venture. Therefore the real estate service provider should only recognize revenue and costs in its income statement for the services provided by its employees.



Example 2 – Contracts with more than two parties

Background: A real estate service provider contracts to be the general contractor (GC) of a new development project for a real estate venture. In return, it is compensated for services through a fixed fee. The GC selects, hires, and oversees/directs the activities of all subcontractors it uses to perform the work; this includes directly negotiating pricing and contracts. In addition, some of the GC's own employees perform the work. The GC takes responsibility for, and guarantees the performance of, its hired subcontractors and employees. If the real estate venture is unsatisfied with the quality of work performed by the subcontractors or GC's employees, GC will be responsible for resolving the quality issues. The GC benefits from any cost savings realized on the job and similarly, guarantees any cost overruns.

Question: With regard to the services provided by the employees of the GC and third-party subcontractors, is the GC the principal for the services provided?

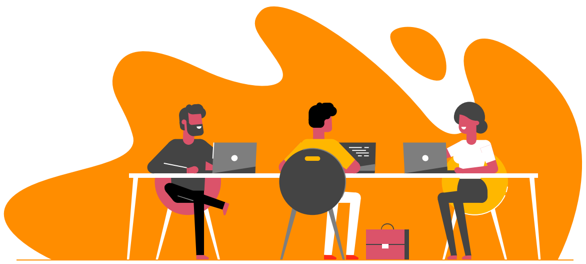
Example 2 – Contracts with more than two parties (continued)

Background: A real estate service provider contracts to be the general contractor (GC) of a new development project for a real estate venture. In return, it is compensated for services through a fixed fee. The GC selects, hires, and oversees/directs the activities of all subcontractors it uses to perform the work; this includes directly negotiating pricing and contracts. In addition, some of the GC's own employees perform the work. The GC takes responsibility for, and guarantees the performance of, its hired subcontractors and employees. If the real estate venture is unsatisfied with the quality of work performed by the subcontractors or GC's employees, GC will be responsible for resolving the quality issues. The GC benefits from any cost savings realized on the job and similarly, guarantees any cost overruns.

Question: With regard to the services provided by the employees of the GC and third-party subcontractors, is the GC the principal for the services provided?

Discussion

The GC is the principal for the services provided by its employees and the subcontractors because it controls the services before the services are provided to the real estate venture. The GC has (1) performance risk, through responsibility for the subcontractors and its employees' performance, (2) inventory risk, through its direct contracting relationship and ability to direct and redirect the subcontractors and employees activities on the development project, and (3) pricing risk, through its ability to set pricing for the project as a whole and its responsibility for cost overruns. Therefore, the fixed fee should be presented in revenue and the costs of the employees and subcontractors should be presented as costs in the income statement.



Lease accounting update

How ASC 842 is impacting real estate investment companies

Debt covenants

Existing Agreements

- Review agreements for GAAP change clauses
- Discuss intention with lenders on an as needed basis

New Agreements

- Generally:
  - Operating leases are not debt
  - Finance leases are debt
- Pay attention to lease classification changes under new standard

Initial direct costs

IDCs include

Incremental costs that an entity would not have incurred if the lease had not been obtained (executed)

Operating leases

If operating lease and lease payments are collectable, defer IDCs and recognize as expense over lease term on same basis as lease income

Non-Operating leases

IDC's will typically be expensed

Included

- Commissions (external) payable only upon successful execution
- Certain payments made to existing tenant to terminate its lease

Excluded

- Employee base salaries
- Legal costs to negotiate and arrange lease terms and conditions
- Costs to evaluate a prospective lessee's financial condition
- Advertising
- Other origination efforts
- Depreciation
- Costs related to an idle asset
- Internal engineering costs

Navigating the new landscape

Financial instruments – Impairment

Impairment overview

Impacts

- Changes determination of losses from incurred loss approach to expected loss approach
- Replaces multiple impairment models
- Could impact regulatory capital requirements
  and key financial metrics
- Convergence will not be achieved
  - FASB – Single measurement lifetime losses
    at inception except for available-for-sale debt securities
  - IASB – Dual measurement lifetime losses upon trigger

Current "incurred loss model" – criticized for delaying timely loss recognition

Model based on an expected loss approach

Recognizes losses on a more timely basis

What's in scope of CECL?

CECL applies to financial assets measured at amortized cost and certain off-balance sheet credit exposures

Scope of the standard

- Loans
- Held-to-maturity debt securities
- Loan commitments
- Trade receivables
- Net investments in sales-type and direct financing leases
- Reinsurance receivables
- Financial guarantees
- Purchased credit deteriorated assets recorded at amortized cost

Specifically excluded

- Loan receivables held-for-sale
- Financial assets for which fair value option is elected
- Equity instruments and equity method investments
- Derivatives
- Related party loans to entities under common control
- Operating lease receivables

Overview of the CECL model

Current Expected Credit Loss model (CECL)

Single measurement objective for assets held at amortized cost: Expected credit losses over the life of the financial asset	No "triggers" before recognizing impairment	CECL reserves are the amount not expected to be collected	The allowance is a valuation account that is deducted from the amortized cost basis to present the net carrying value at the amount expected to be collected

CECL measurement principles

- Financial assets within scope **must be pooled** when similar risk characteristics exist; otherwise assessed individually
- Use of a discounted cash flow model is not required
- The allowance should be calculated based on the amortized cost basis of the financial asset
- Consider relevant internal and external information, including:
  - Historical experience
  - Current conditions
  - Reasonable and supportable forecasts
- Future periods beyond which the entity is able to make a reasonable and supportable forecast – reversion to historical loss information

Time horizon for measurement of CECL

- Estimate of expected credit losses = amount that an entity does not expect to collect over the life of the asset
- “Life” of the asset considers the contractual term and expected pre-payments but not renewals, modifications, or extensions (except if outside the lender’s control), unless a troubled debt restructuring is reasonably expected
- Off-balance-sheet credit exposures:
  - Consider the period over which the commitment is legally binding
  - Do not consider obligations that are unconditionally cancellable at the lender’s discretion
- Financial guarantees will have allowances similar to an unfunded commitment

CECL – Other key considerations

- Consideration of collateral
  - Mitigation of credit risk
  - Measurement when foreclosure is probable
  - Collateral-dependent financial assets
- Impact of “embedded” vs. freestanding credit enhancements
- Other allowance considerations:
  - Trade receivables
  - Net investments in leases (capital leases)

Example – CECL model – Initial recognition

- Entity A purchases (or originates) portfolio of non-amortizing bonds and classifies them as held-to-maturity
- The bonds share similar risk characteristics
- Entity A estimates the following expected credit loss rate for the portfolio:

Characteristics		Expected loss rate estimate		
Purchase price ($)	100M	Historical loss rate	1.5%	A
Premiums/(discounts)	None	Adj. current conditions	+0.1%	B
Remaining estimated life	10 years	Adj. forecast & reversion	+0.05%	C
Coupon	5%	Expected credit loss (Day 1)	1.65%	A+B+C

Accounting entries on initial recognition:			
Dr. Bonds		$100M	
	Cr. Cash		$100m
Dr. Credit expense (P/L)			$1.65M (100M X 1.65%)
	Cr. Allowance		$1.65M

Key differences from incurred loss models

Before	After
ASC 450 (FAS 5) for incurred losses in the loan portfolio (collectively evaluated for impairment)	• Replace incurred loss model with expected loss model • Reasonable and supportable forecasts • Reflects contractual life considering prepayments, but without consideration of renewals, extensions (except if outside the lender's control), or modifications, unless TDR is reasonably expected • Expected recoveries of amounts previously written off reduce the allowance (not to exceed amounts previously written off) vs. recording when received under current GAAP
ASC 310 (FAS 114) specific valuation allowances	• No threshold for identification of individually impaired loans • Measurement approach is similar to today if the entity elects to use a discounted cash flow modeling approach
ASC 310-40 TDRs	• Measured using the CECL model • Recognize credit losses, including certain concessions
ASC 310-30 Purchased Credit Impaired	• Purchased with more than insignificant credit deterioration (PCD) • Basis "grossed up" to reflect expected loss estimate • Initial credit loss will not be recognized in income • Changes in allowance recognized immediately in income • Follow an "accrete to contractual" interest model

Available-for-sale debt security impairment model

Similar approach to current impairment guidance under ASC 320 with the following changes:

- Modified approach will require impairment losses to be accounted for as an allowance subject to future reversal upon credit improvements
- Duration of loss is no longer a consideration in determining whether a security is impaired
- No forecasts of future recoveries after the balance sheet date
- No explicit requirement to evaluate the historical volatility of the fair value of a security
- Measurement and recognition of credit losses are “capped” at the excess of amortized cost over fair value

Measurement of credit loss based on the present value of expected cash flows (a discounted cash flow calculation is **required)**

Purchased financial assets with credit deterioration

Scope: Assets with more than insignificant deterioration in credit quality since origination

- Basis “grossed up” to reflect expected loss estimate on day 1
- Initial credit loss not recognized in income
- If a discounted cash flow (DCF) model is used:
  - Step 1: Calculate the effective interest rate (EIR) by solving for the discount rate such that discounted expected cash flows equal the purchase price
  - Step 2: Calculate the initial allowance by discounting the cash flows not expected to be collected (i.e., difference between contractual and expected cash flows) by the EIR
- Loans:
  - If a non-DCF model is used, the day 1 allowance is based on “par”
- Available-for-sale debt securities:
  - A discounted cash flow approach is required at **the individual security level**
- Subsequently CECL or the available-for-sale debt securities impairment model is applied
  - Interest is recognized using an “accrete to contractual” model

Example – PCD model – Initial recognition

- Entity A purchases a loan
- Loan has experienced more than insignificant credit deterioration since origination
- Entity A uses a discounted cash flow approach to estimate credit losses

Loan characteristics

Purchase price ($)*	70MM	Amortizing	No
Premiums or (discounts) ($)	(30MM)	Allowance (Day 1)* ($)	18.84MM
Remaining estimated life	5 years	Effective interest rate	13.19%
Coupon	10%	Undiscovered cash flows not expected to be collected ($)	35MM

* Present value of cash flows not expected to be collected

Accounting entries on initial recognition:	
Dr. Loan	70MM (purchase price)
Dr. Loan	18.84MM (balance sheet gross-up)
Cr. Cash	70MM (purchase price)
Cr. Allowance	18.84MM (record allowance on PCD)

Disclosure requirements

Allowance for credit loss roll forward schedule	• Disclosure of the rollforward of the allowance for credit loss on assets subject to CECL and on available-for-sale debt securities is required
Credit quality indicators	• Includes disclosure requirements for credit quality indicators (CQI) • This requirement is not applicable to short-term trade receivables • Expanded disclosures of amortized cost basis within each CQI by “vintage,” or year of asset origination • The new standard: - Exempts non-public business entities from the vintage disclosures - Provides transition relief for public business entities (PBEs) that are non-SEC filers: • On the initial date of adoption, preparers only need to disclose the most recent three years of vintage CQI data • Each fiscal year thereafter, an incremental year of vintage CQI data should be disclosed until five separate fiscal years are disclosed - Does not provide transition relief or exemptions for PBEs that are SEC-filers

Transition guidance

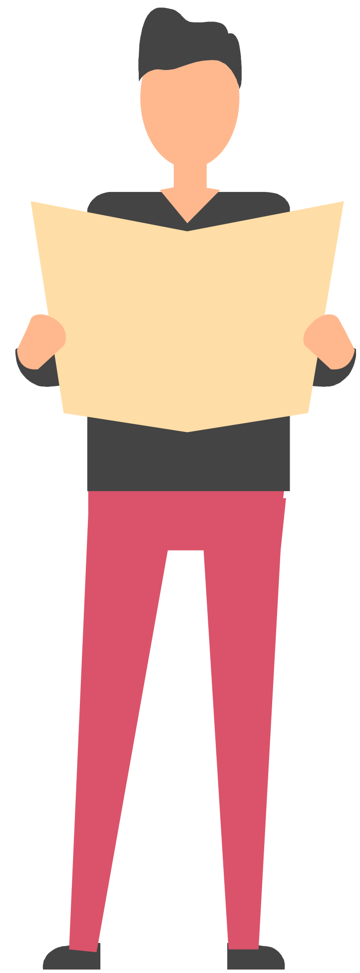
Generally, a cumulative transition adjustment will be required on the date of adoption

Purchased financial assets with credit deterioration

- Current purchased credit impaired (PCI) financial assets will be classified as purchased financial assets with credit deterioration (PCD) at transition
- PCD guidance will be applied prospectively for financial assets that previously applied the PCI model
- On date of adoption, record allowance for credit loss “gross-up” to the balance sheet

Debt instruments that experienced other-than-temporary impairment

Adopt ASU prospectively



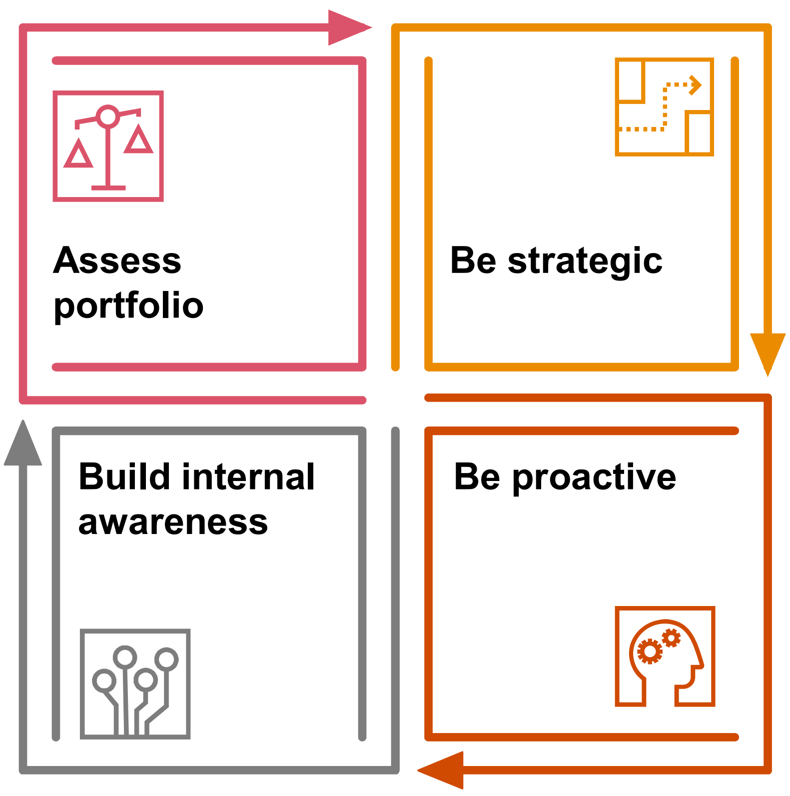
Impacts to companies

Changes are coming

- Will significantly affect banks and other financial institutions
- Potential to affect most companies
- Models, systems, controls and processes will need to be evaluated
- Many functional areas will be affected

Actions to consider

- Monitor developments
- Identify key stakeholders
- Identify financial assets affected
- Estimate the impact
- Consider potential changes to impairment measurement, controls, and processes



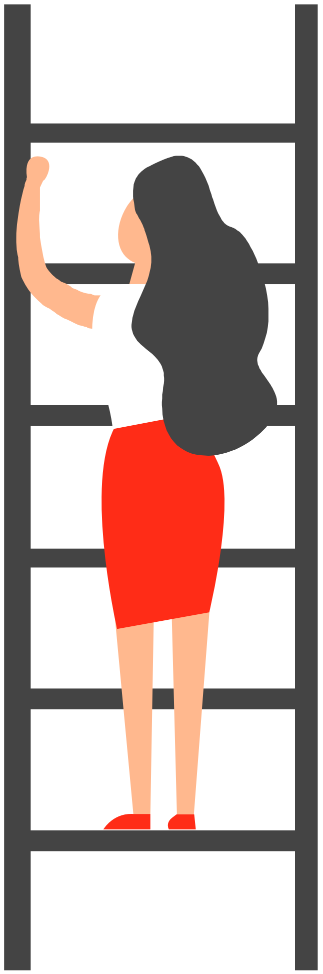
Next steps

Effective dates

- Public business entities (PBEs) that meet the definition of an SEC filer: in fiscal years beginning after December 15, 2019 including interim periods within those fiscal years (i.e., 2020 interim and annual financial statements for calendar year entities);
- PBEs that do not meet the definition of an SEC filer: in fiscal years beginning after December 15, 2020, including interim periods within those fiscal years (i.e., 2021 interim and annual financial statements for calendar year entities); and
- Non-PBEs, including certain not-for-profit entities and employee benefit plans: In fiscal years beginning after December 15, 2021 and interim periods within those fiscal years (i.e., 2022 interim and annual financial statements for calendar year entities)
- Early application of the guidance is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.
- IFRS 9: Annual periods beginning on or after January 1, 2018

CECL – Transition Resource Group

The FASB created a transition resource group, similar to the revenue standard



Reminder on new and upcoming standards

Reminder on other new and upcoming standards

Standard	PBE Effective Date	Non-PBE Effective Date	Early Adoption Permitted
New revenue standard (ASC 606)	January 1, 2018	January 1, 2019	Yes
Derecognition of nonfinancial assets and equity method investments (ASU 2017- 05)			
Statement of cash flow – restricted cash (ASU 2016- 18)			
Statement of cash flows – presentation of certain transactions (ASU 2016- 15)			
New definition of a business (ASU 2017-01)			
Fair Value Measurement (Topic 820) (ASU 2018-13)	January 1, 2020		

Classification of certain cash receipts and cash payments (ASU 2016-15)

Issued August 2016

Impacts

- Provides guidance for eight cash flow issues
- Reduces diversity in practice
- Improves comparability of the statement of cash flows across all entities

Prior guidance either was unclear or did not include specific guidance on the eight cash flow classification issues

1) Debt prepayment or debt extinguishment costs
2) Settlement of zero-coupon debt instruments or other debt instruments with insignificant coupon rates in relation to the effective rate
3) Contingent consideration payments made after a business combination
4) Proceeds from settlement of insurance claims
5) Proceeds from the settlement of corporate- owned and bank-owned life insurance policies
6) Distributions received from equity method investees
7) Beneficial interests in securitization transactions
8) Separately identifiable cash flows and application of the predominance principle

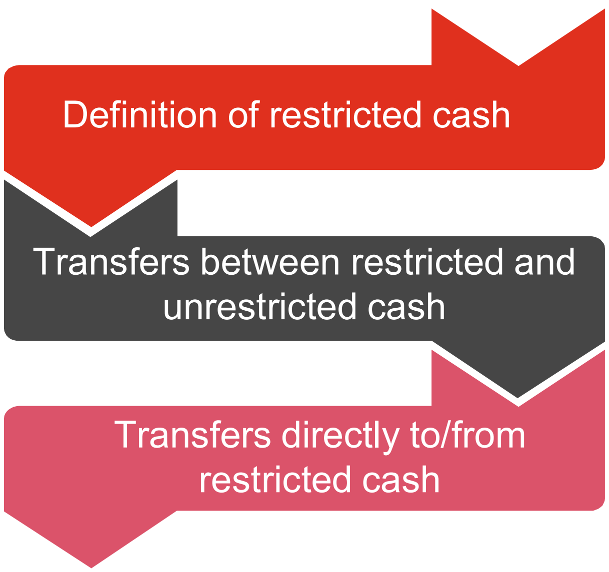
Restricted cash – ASU 2016-18

Issued November 2016

Impact: The statement of cash flows will reconcile to the total of cash, cash equivalents, restricted cash, and restricted cash equivalents. Transfers between cash and restricted cash will not be presented separately, and only cash flows with third parties will be presented.

Issue

- Diversity in the presentation and classification of changes in restricted cash on the statement of cash flows.



Final consensus

- Restricted cash will be presented with cash and cash equivalents within the statement of cash flows.
- Entities will be required to reconcile amounts on the balance sheet to the statement of cash flows and disclose the nature of restrictions.

Fair value disclosures overview (ASU 2018-13)

Issued August 2018

Impacts

- Eliminates, amends, and adds disclosure requirements for fair value measurements
- Companies can choose to early adopt the eliminated and amended disclosures early and wait to adopt the new disclosures until the effective date

Applies to all entities that are required, under existing GAAP to make disclosures about recurring or nonrecurring fair value measurements.

Eliminates fair value disclosures

All companies

- Amount of and reasons for, transfers between Level 1 and Level 2
- The policy of timing of transfers between levels
- The valuation processes for Level 3 fair values (Note: disclosure of valuation policies, techniques and approach is still required)

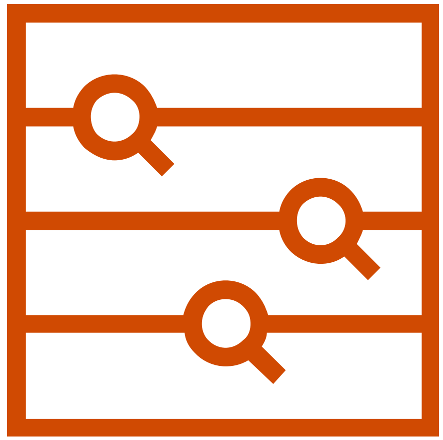
Nonpublic companies

- Changes in unrealized gains/losses included in earnings for recurring Level 3 fair value measurements for instruments held at the end of the period

Amends fair value disclosures

Description	Existing disclosure	Amended disclosure
Liquidity events for investment in entities that calculate a NAV (cannot be redeemed)	Estimate and disclose the timing	Only disclose if the investee has communicated the timing to the company or announced publicly
Nonpublic companies only		
Level 3 roll forward	Required to be disclosed	No longer required-instead, disclose the following for Level 3 (by asset class): • Transfers in/out • Purchases/issues
Public companies only		
Measurement uncertainty	Describe the sensitivity of the fair value changes in inputs	Describe the measurement uncertainty of the fair values to changes in inputs at the **reporting** date (clarifies that there is no requirement to disclose future changes)

Effective date and transition



Effective dates- same for public and private

- All fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2019
- Permitted to early adopt any eliminated or amended disclosures upon issuance and delay the adoption of additional disclosures until the effective date

Transition

- **Prospective** for:
  1. Changes in unrealized gain and losses
  2. Range and weighted average of significant unobservable inputs
  3. Narrative description of measurement uncertainty
- **Retrospective** for all other amendments

The eliminated and amended disclosures can be early adopted!

Thank you

pwc.com

In depth

Application of CECL to leasing

No. US2019-05
May 2, 2019

What's inside

At a glance

The new credit impairment model for financial assets reported at amortized cost will be applicable to receivables associated with sales-type and direct financing leases but not to operating lease receivables. The CECL model requires recognition of an allowance for credit losses on the date that a sales-type lease or direct financing lease receivable is recognized, either through origination or acquisition. A variety of techniques may be used to estimate the allowance, but the company's estimate of expected credit losses must include a measure of the expected risk of credit loss even if that risk is remote. Considerations in application of the model are addressed in this *In depth*.

Companies should continue to build and test models to develop credit loss estimates for lease receivables and follow future discussions. The FASB continues to discuss certain elements of the credit loss guidance, and recently issued codification improvements. Industry groups continue to discuss implementation questions, such as potential differences in the treatment of termination and extension options under the leasing and credit losses guidance. For further information, see PwC's *Loans and investments* guide.

Scope of CECL: leasing

The new current expected credit loss (CECL) impairment model is applicable to lessors for certain types of leases. The CECL model applies to net investments in leases associated with sales-type leases and direct financing leases. The FASB recognized that these receivables include both financial and non-financial elements, but concluded that the application of a single impairment model to the recognized lease asset would be preferable to assessing different components of a single asset under different impairment models.

The FASB recently amended the CECL guidance to clarify that receivables arising from operating leases are not within the scope of CECL. The FASB noted that the new leases standard has a specific model to assess the collectability of operating lease payments and guidance on how to recognize lease income based on those payments that is operational and well understood.

The leasing guidance is effective for calendar year public business entities, not-for-profit entities that have issued or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC. Other entities have an additional year to adopt.

CECL is effective for calendar year public business entities that meet the definition of an SEC filer on January 1, 2020. Public business entities that do not meet the definition of an SEC filer have an additional year to adopt and other entities have an additional 2 years to adopt.

Components of a net investment in a lease

The net investment in a lease has a number of components. Some of the components are financial elements that involve credit risk as that term is traditionally thought of, that is, the risk that a party may fail to perform on its obligation. Other components of the balance involve non-financial risks.

Financial components

The financial components of the net investment in a lease include rental payments and any residual value guarantee where the lessee or guarantor could fail to perform on their obligations. The rental payments are an obligation of the lessee to make payments that are collateralized by the leased asset. In the event the lessee defaults on its obligation to make rental payments, the lessor generally has a right to the return of the leased asset, which mitigates any losses incurred as a result of a lessee default. This is similar to a collateralized loan in which a lender can foreclose or seize the collateral if a borrower defaults.

Non-financial components

Some net investment in lease balances also include a non-financial component relating to an estimated unguaranteed residual value of the leased asset. This represents a contractual right that is not a stated contractual cash flow. The value of the right to the return of the asset at the end of the lease depends on the value of the asset at that time. In addition, unlike in most traditional loans, if the lessee defaults on its obligation and the lessor repossesses the leased asset, the lessor does not return any excess of the value of the leased asset over what the borrower owes. Thus, there is a potential for an economic gain upon obtaining the leased asset either through repossession or upon return of the leased asset at the maturity of the lease.

The lessee might also have an option embedded in the lease to purchase the leased asset at a stated price. This option may impact the cash flows that would be received as compared to a lease without a purchase option if, for example, the residual value of the asset is higher than the purchase price.

Other components

A net investment in a lease may have other components that impact its amortized cost balance, including deferred selling profit or deferred costs. While these amounts may not be a source of future cash flows, they impact the amortized cost basis of the net investment of the lease and therefore may impact the CECL estimate. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net amount expected to be collected on the financial asset.

Impact of CECL on lease receivables

Initial recognition

The CECL model requires an allowance for credit losses to be recognized on the date that a sales-type lease or direct financing lease receivable is recognized, either through origination or acquisition. The guidance requires an entity's estimate of expected credit losses to include a measure of the expected risk of credit loss even if that risk is remote. It also requires that the measurement of credit losses be on a collective (pool) basis when individual assets share similar risk characteristics.

For leases that are originated, the initial measurement of the allowance for credit losses will be recorded through earnings.

For leases that will be accounted for as sales-type or direct financing leases acquired either though a business combination or an asset purchase, we believe an entity should assess whether the acquired leases would be considered purchased credit deteriorated (PCD). To the extent a lease is not considered PCD, the initial measurement of the allowance for credit losses would be reported in current earnings (similar to an originated lease). If a lease is considered PCD, the initial measurement of the allowance for credit losses will create a basis adjustment to the amortized cost basis of the net investment in lease. This is commonly referred to as a "gross up" as the initial entry to establish the allowance adjusts the carrying value of the asset. See PwC's *Loans and investments* guide for additional information on the purchased credit deteriorated model.

The PCD initial recognition model is an integral part of the new credit impairment guidance. Since the FASB concluded that the impairment of sales-type and direct financing leases should follow the CECL model (of which the PCD guidance is a component), we believe that the PCD guidance is applicable to these leases as well.

Since a net investment in a lease balance includes non-financial elements, these elements will impact the determination of whether the net investment is considered PCD. For example, the estimated residual value of the leased asset will impact the net investment in a lease. If there has been a decline in the estimated residual value, this decline in value is considered a credit loss and therefore could impact whether the net investment in the lease is considered PCD if acquired. In addition, declines in the estimated residual value of the leased asset since the lease's origination could impact the amount of the "day one" allowance for a lease. To estimate the allowance upon acquisition of a lease, the purchaser will need to estimate what the residual value of the asset at the end of the lease was forecasted to be at the inception of the lease.

One of the objectives of the PCD model is that after initial recognition, the originated assets and purchased assets that have experienced credit deterioration will apply the same credit loss and interest recognition models. The "gross up" that is recorded as an adjustment to the amortized cost basis of the net investment in the lease will impact the calculation of lease income over the life of the lease. The allowance would be released with an offset to earnings if estimated collections improve, similar to the treatment for originated assets.

Estimating credit losses under CECL

In developing the CECL model, the FASB consciously allowed for a variety of acceptable techniques to estimate credit losses. Entities can utilize discounted cash flow models, undiscounted approaches, such as loss rate or probability of default/loss given default models, or other models.

With respect to sales-type and direct financing leases that have financial and non-financial components, entities should consider a number of factors in their analysis.

Rental payments

The rental payments component of the net investment in leases could be thought of similar to a collateralized loan with an amortizing principal balance. This component consists of contractually specified payments on specified dates and if the lessee defaults, the lessor has the ability to repossess the leased asset similar to a lender's ability to foreclose on collateral for a loan. In this context, consideration should be given to the probability that the lessee will default and the loss given default considering amounts that may be collected from the lessee as well as the ability to obtain the leased asset.

Residual value of the leased asset

Obtaining the asset at the maturity of the lease is dependent on the lease reaching its maturity. To the extent the lessee defaults, the loss incurred by the lessor is dependent on the fair value of the leased asset when repossessed as opposed to at maturity.

In some instances, the fair value of the leased asset may be forecasted to decline at a different pace than the amortized cost basis of the net investment in the lease. This could impact credit modeling at inception if it is forecasted that at different points in the life of the lease, the degree to which the rental payments are collateralized changes. For example, if the fair value of the leased asset declines in the early years of a lease faster than the amortized cost basis of the net investment, different losses may be realized depending on when a default is estimated to occur. This should be considered in an entity's estimate of credit losses, and may be captured in an entity's historic loss information, which may serve as a starting point for estimating credit losses.

Residual value guarantee

The leasing guidance requires certain residual value guarantees to be considered in determining the lease classification and the measurement of the initial recognition of the net investment in the lease. As such, we believe that it should be considered in the assessment of credit losses.

This may result in considering the impact of residual value guarantees when seemingly similar credit insurance arrangements would not be considered. ASC 326 indicates that credit insurance arrangements that are considered freestanding contracts would not be considered in determining the allowance for credit losses. However, we believe that guidance was written in the context of loan accounting, in which freestanding credit insurance agreements are not considered in the determination of the initial carrying value of the loan as they are not part of the same unit of account. If under the leasing guidance, the unit of account of the lease includes the residual value guarantee, we believe the unit of account for the purposes of determining credit losses should include the residual value guarantee as well.

In considering the impact of any residual value guarantee, the degree to which the estimated fair value of the residual asset is below the guaranteed amount, as well as the credit risk of the guarantee provider, will be key inputs into modelling the impact of such guarantees.

Pooling of leases

The CECL model requires the measurement of credit losses to be on a collective (pool) basis when individual assets share similar risk characteristics. The implementation guidance provides some examples of factors that could be used to identify assets that share similar risk characteristics. Many of these factors (e.g., credit rating of the lessee, remaining term of the lease) will be relevant when considering if leases share similar characteristics.

The nature of the leased asset will likely be a key consideration in determining whether leases share similar characteristics. The value of the leased asset can impact the estimate of expected credit losses both with respect to serving as collateral against rental payments and based on its residual value. The volatility of the value of a leased asset, whether the value of the assets is correlated amongst the leases, and other similar considerations will also be relevant. For example, it may not be appropriate to create a single portfolio of auto leases that includes some leases of small cars and others for large pickups and SUVs as those assets would not be expected to have similar risks with respect to their residual values.

At the June 11, 2018 Transition Resource Group for Credit Losses (TRG) meeting, the FASB staff shared their perspectives that expected gains on the disposal of leased assets should be included in an estimate of expected credit losses for a pool of lease receivables. Including expected gains serves to reduce credit losses within the pool ("offsetting" losses such as lessee default or declines in the residual value of other assets).

Some noted that using expected gains on the disposition of leased assets to offset credit losses effectively includes that gain in earnings before it is realized. In their conclusion, the FASB staff noted that the guidance requires the net investment in lease (including the residual value of the asset) to be evaluated as a single unit and that a pool-level assessment does not preclude including cash flows associated with the disposition of the asset.

To the extent that a pool includes leases with substantial expected gains on the disposal of the leased assets and substantial losses on the disposition of other leased assets, this may indicate that the leases do not share similar risk characteristics. As a result, the leases may need to be assessed as part of other pools of leases or be assessed individually for credit losses if they no longer share common risk characteristics with other leases.

The existence of a residual value guarantee (that is considered part of the unit of the account of the lease) and the credit risk of the provider of that guarantee (whether it is the lessee or a third party) may also be key factors in evaluating whether leases share similar risks characteristics.

Other considerations in applying CECL to lease receivables

Write off policies

Estimated credit losses on sales-type and direct financing lease receivables are reflected through an allowance for credit losses account, which is separately reported in the financial statements as a deduction from the amortized cost basis of the asset. The CECL model requires assessments of allowance amounts to determine whether they should be written off against the amortized cost basis of the receivables. Receivables (and allowance accounts) are written off either in full or in part when such amounts are deemed uncollectible.

For leases, each component of a lease receivable (financial or non-financial) could cause a write-off.

Companies may need to establish policies and procedures to determine when receivables (and allowance balances) should be written off.

Collateral dependent leases

The credit loss guidance provides a practical expedient under which an allowance can be measured based upon the difference between the fair value of collateral and the amortized cost basis when the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral. If collection would be achieved through the sale of the collateral, costs to sell must also be considered. This method of calculating an allowance is required when foreclosure is deemed probable.

The collateral dependent practical expedient and the requirement to use collateral value when foreclosure is probable are elements that are integral to the CECL model. As a result, similar to the PCD guidance, we believe that the collateral dependent practical expedient could be used for leases and the requirement to use collateral value when "foreclosure" is probable should be applied to leases.

We do not believe that this guidance should be applied in situations when the lessee has performed (and is expected to perform) on its obligations to make payments and the leased asset is returned to the lessor at the expiration of the lease in accordance with the lease's contractual provisions. However, if the lessee is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the leased asset following repossession, we believe that the collateral dependent practical expedient can be applied. In addition, if it is probable that the lessee will default and the lessor will repossess the leased asset, we believe that the fair value of the leased asset must be used in the determination of the allowance.

Sale of lease receivables

In some cases, a lessor may sell the receivable associated with future rental payments but retain ownership of the leased asset. ASC 860 is the applicable guidance for determining whether that transfer would be accounted for as a sale resulting in derecognition of the receivable. In instances when the transfer of the receivable is accounted for as a sale, and the asset remaining relates to the unguaranteed residual value, the leasing guidance states that the lessor should begin applying ASC 360, *Property, Plant and Equipment*, to determine whether the unguaranteed residual asset is impaired. As a result, the CECL model would no longer be applicable.

We do not believe that this guidance should be extended to address situations when the lessor has not transferred receivables and simply as a result of a lessor making payments, the net investment of the lease consists principally of the estimated residual value of the leased asset. In these situations, we believe it is appropriate to continue applying the credit loss model in ASC 326 until the leased asset is obtained.

To have a deeper discussion, contact:

John Bishop
Partner
Email: john.bishop@pwc.com

Angela Donnelly
Director
Email: angela.l.donnelly@pwc.com

Chip Currie
Partner
Email: frederick.currie@pwc.com

Marc Jerusalem
Director
Email: marc.jerusalem@pwc.com

For more PwC accounting and reporting content, visit us at pwc.com/cfodirect. On the go? Take our podcast series with you at pwc.com/cfodirect/podcasts.

How the new revenue standard affects fee arrangements in the real estate industry

Adopting the new revenue standard may create challenges specific to various forms of fee arrangements common to entities in the real estate industry

At a glance

Revenue recognition in the real estate asset management industry can be complex because there are many variations of investment structures aimed at achieving yield or appreciation for investors. In addition, there are quite a few different fee structures designed to compensate the managers. For example, there are management fees based on assets under management and performance fees based on the internal rate of return (IRR) of the fund compared to benchmark targets or a specified target hurdle rate of return. Real estate asset managers will recognize as revenue the amount they expect to be entitled to in exchange for the transfer of services, subject to a "constraint." The constraint will limit the amount of consideration that may be currently recognized to that which is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

The impact of the new revenue standard will vary depending on an entity's existing accounting policies. Upfront costs and performance-based fees are two areas that could be most affected. Key issues real estate asset management companies will need to address include identifying the customer, determining the distinct performance obligations, and estimating variable consideration.

Identifying the customer

The new standard requires an entity to identify the contract with the customer. Deciding which party is the customer (i.e., the fund or the investor) has ramifications throughout the revenue model and might significantly affect how the standard is applied. Management will need to weigh different factors, and make a conclusion based on the facts and circumstances and overall relationship.

While not conclusive, certain factors in isolation may point to the fund or the investor being the customer. A factor that points to the fund being a customer is a fund's ability to enter into contracts with third parties for additional services, such as fund accounting or transfer agency activities. Highly-regulated funds, such as registered investment companies, typically have hundreds of investors, none of whom are deemed to have influence over the contracts between the fund and service provider; instead, the fund's board of directors governs these relationships. For example, in many registered investment companies, some investors purchase shares through a third-party distributor that holds the shares in an omnibus account along with other investors. An omnibus account is often used by third-party distributors to simplify the subscription and redemption process into a fund. There may be situations when the asset manager does not have visibility into the underlying investors that make up the omnibus account.

In other situations, factors may point to the investor as the customer. If the investor is heavily involved in negotiating specific fees, or interacts directly with the manager to set up the fund strategy, this could indicate that the investor is the customer. This may be the case for funds that have a single or very few investors, thus the investors have the potential to play a more direct role in the investing or tax activities of the fund or negotiation of the asset management relationship. If the asset manager enters into "side letter" arrangements with an individual investor, this could also indicate the individual investor is a customer.

The evaluation of which entity is the customer may be complex. In our view, the conclusion should be based on the facts and circumstances of each arrangement and should not be viewed as an accounting policy election.

To illustrate the potential impact of who the customer is in regard to capitalizing contract costs, consider the following. An investor purchases an investment via a subscription agreement in an open-ended real estate fund. The fund has been in operation for a number of years and has a number of other investors. The investment manager will pay a fee to a third-party placement agent for the successful placement of the investor into the fund. The investor works closely with the investment manager to structure its investment for tax purposes, negotiates the management fee it will pay on its investment and provides input into additional real estate assets that could be acquired with its committed capital. In this example, if the investor is the customer, the placement fee could be capitalized and amortized over the term of the contract (i.e., subscription agreement) with the investor, which would represent the minimum required hold period (lock-up period) in which the investor is required to commit its capital. Conversely, if the fund is deemed the customer, the placement fee would be expensed as incurred because it would not represent a cost to obtain or fulfill a contract with a customer as the fund is already in operation and the fulfilment period is over.

Performance obligations

Different performance obligations may be satisfied at different times - so having more than one performance obligation in a contract may impact the timing of revenue recognition. Real estate asset managers are often entitled to several different fees, such as management fees, distribution fees, and fees associated with the acquisition and disposition of investments. The new standard requires a manager to identify distinct performance obligations. Because the assessment of whether a promise gives rise to a performance obligation is from the perspective of the customer, the conclusions regarding who the customer is may impact this evaluation.

Even though services and related fees may be included in different contracts, they could still represent a single performance obligation. The new standard requires an entity to combine contracts that are entered into at or near the same time and with the same customer and account for them as a single contract if (1) they are negotiated as a package, (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, or (3) the services in the contracts represent a single performance obligation. For a real estate asset manager, the contracts are often entered into at the same time, usually at the start of a fund, and are often viewed as a single arrangement. However, the real estate asset manager should consider if the services are distinct.

A service is distinct if (1) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (2) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. If a service is not distinct, the entity must combine the services until such a point that a bundle of services are viewed as distinct. A good or service that the entity regularly sells separately is an indication that the customer can benefit from the good or service on its own or with readily-available resources.

Some asset managers sell distribution services separately. This indicates the service is capable of being distinct, and therefore the asset manager would likely conclude that the distribution service is separately identifiable based on the fact that (1) asset managers typically do not provide a significant service of integrating the distribution service with other services promised in the contract into a bundle of services that represent the combined output for which the customer has contracted, (2) the various services do not significantly modify or customize one another, and (3) the services are not highly interdependent or highly interrelated because the asset manager would be able to fulfil each of its promises independent of the others.

Revenue recognition will also depend on whether the real estate asset manager's promise meets the criteria to be accounted for as a series; that is, is it a promise to transfer a series of services that are substantially the same and that have the same pattern of transfer to the customer over time. Asset management services are generally considered a series of distinct services, as described in Example 25 in ASC 606-10-55-221. (However, Example 25 does not identify which services would be considered asset management services. As such, the asset manager must still assess whether the placement services are distinct from asset management services.)

A series of distinct services provided over time is accounted for as a single performance obligation. When a contract includes a series accounted for as a single performance obligation and also includes an element of variable consideration (as further described in the next section), management should consider the distinct goods or services (rather than the series) for the purpose of allocating variable consideration (as long as the allocation objective is met).

On a closed-end real estate fund, a real estate asset manager provides fund management services (e.g., day-to-day management of fund investments, purchase and sale of underlying assets, accounting/reporting, and other related services). In consideration for its services, assume the asset manager earns a base management fee of 1.5% of assets under management (AUM) and a performance-based incentive fee of 20% of the fund's returns in excess of a 10% internal rate of return (IRR) at the end of the fund's life. If the real estate asset manager determines that the series guidance applies, it would record the base management fee at the end of the month because the uncertainty (i.e., the fund's AUM), has resolved itself and the fee earned is associated with the distinct services provided over the month. However, the real estate asset manager may conclude it is not appropriate to record any of the performance-based incentive fee because it is not probable that a significant reversal of the cumulative revenue recognized will not occur when the uncertainty (i.e., the actual IRR at the end of the fund's life) is resolved.

Variable consideration

Under the new revenue standard, the "transaction price" is the consideration the asset manager expects to be entitled to in exchange for satisfying its performance obligations. One of the primary performance obligations in the real estate asset management industry is the delivery of asset management services. This performance obligation is often a series of distinct services satisfied over time as asset management services are delivered. Management must determine the amount of the transaction price at contract inception and at each reporting date.

Management fees are often based on committed or invested capital, while performance fees are usually based on profits generated from the underlying investments held by the funds subject to certain thresholds (e.g., hurdle rate, high watermark, or internal rate of return). As such, management fees and performance fees are forms of variable consideration. Real estate asset managers may receive variable incentive-based capital allocations in lieu of cash as payment for the services. These arrangements, called carried interest, are discussed in the sections and examples that follow.

If the amount the asset manager expects to be entitled to is variable, the consideration included in the transaction price is limited to the amount for which it is probable that a significant reversal of the cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. This is commonly referred to as the "constraint" on variable consideration, which must be disclosed in the footnotes to the financial statements. In making this assessment, an entity should consider both the likelihood and the potential magnitude of revenue reversal. Factors that could increase the likelihood or the magnitude may include: (1) the amount of revenue is highly susceptible to factors outside the entity's influence (e.g., market volatility), (2) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, and (3) the contract has a large number and broad range of possible consideration amounts. Refer to Section 4.3.2, *Constraint on variable consideration*, in PwC's *Revenue from Contracts with Customers* guide for more information.

Management will need to determine if there is a portion of the variable consideration (i.e., some minimum amount) that should be included in the transaction price, even if the estimate of the entire variable consideration is not included due to the constraint. Management's estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.

The contractual measurement period for performance fees for many real estate asset managers may be quarterly or at the end of the fiscal year for open-ended funds. In many cases, the performance fees will be constrained until this contractual measurement period is completed. This means that the revenue will generally not be recognized in full in the interim periods (for example, at the end of each quarter, unless the fee is earned each quarter). However, management will need to determine if there is a portion (a minimum amount) of the variable consideration that should be recognized prior to the end of the contractual measurement period. The full amount of the fee will likely be recognized as of the end of the contractual measurement period when the asset manager becomes entitled to an amount that is fixed. In certain cases, the full amount of the fee will be recognized upon a crystallization event (e.g., redemptions) because the amount becomes fixed at that time and is no longer subject to reversal.

Real estate asset managers of closed-end funds (e.g., 7-year finite life) often receive performance fees (typically in the form of carried interest) that are subject to clawback on a cumulative basis based on the performance of the fund over its life. If a fund makes a distribution to the manager, it is possible the manager will have to return the cash distribution if the fund underperforms in the future. An entity will need to consider whether the existence of a claw back provision results in the need to constrain some or all of the revenue for the services provided. However, the lack of a claw back provision on cash received does not necessarily indicate that the entity is able to recognize the amount as revenue if the performance obligation has not yet been satisfied.

For funds with a finite life, real estate asset managers will need to evaluate the appropriate time when the carried interest (or a portion thereof) is not constrained by the variable consideration guidance. This may happen before the end of the fund's life. If a fund were to assess performance fees in relation to a high watermark, there may be a point in time in the later years of a fund's life cycle when the fee is no longer constrained given the fund's cumulative performance in relation to its remaining assets. For instance, there could be a point in time when a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the high watermark; therefore, a portion of the carried interest may no longer be constrained and should be recognized as revenue.

The following table summarizes the new guidance for management and performance fees, and compares the new revenue standard to prior accounting.

New revenue standard	Prior US GAAP
Management fees: A fixed percentage asset-based management fee is considered a type of variable consideration that is subject to the constraint. For management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will be resolved as of the end of each reporting period. The asset manager will attribute the revenue from management fees to the services provided during the period because the fees relate specifically to the entity's services for that period.	**Management fees:** A fixed percentage asset-based management fee is earned for providing asset management services. These fees are generally recognized as revenue each period in accordance with the terms of the asset management contract.
Potential impact: In general, the accounting for management fees that are based on current assets under management and are not subject to clawback is not expected to change.	
Performance fees: Return-based performance fees are also considered variable consideration. The real estate asset manager should recognize revenue only if, after an assessment of the facts and circumstances, it is probable the amount of variable consideration would not result in a significant reversal of cumulative revenue recognized when the uncertainty is resolved. Performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management's estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration. The FASB has expressed that it was the Board's intention that the new guidance would cover incentive-based capital allocations; it believes ASC 606 addresses asset manager service contracts regardless of whether the fee is paid in cash or a capital allocation. It is the FASB's	**Performance fees:** Performance fees based on a formula that are tied to returns subject to performance targets (i.e., high watermark) may be recognized using one of two methods. Under Method 1, performance fees are recognized in the periods during which the related services are performed and all the contingencies have been resolved. For private equity real estate fund managers, this typically occurs upon termination of the fund or when distributions from a fund exceed the clawback portion of the historic performance fees distributions. Under Method 2, performance fees are recognized as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date (otherwise known as the "hypothetical liquidation method"). As a result, there is a possibility that revenue recognized for fees earned by exceeding performance targets early in the measurement period could be reversed due to missing performance targets later in the measurement period.

view that the fees are designed to compensate the manager for services performed.[1] However, the SEC staff did not object to the conclusion in certain asset manager fact patterns that partnership investment (inclusive of the carried interest) could be accounted for in accordance with ASC 323, *Investments-Equity Method and Joint Ventures*.

Potential impact:

Application of the new revenue guidance may result in significant changes for entities that recorded performance fee revenue under Method 2, given the new guidance requires a higher degree of certainty regarding the amount of the performance fee before revenue can be recognized.

On the other hand, those applying Method 1 will need to consider whether a minimum amount of consideration should be recognized at an earlier point in time.

Example 1: Management fees

Facts: A real estate asset manager has a management contract with a fund to provide asset management services. The management fee is 1% of the fund's net assets and is paid quarterly with no potential for clawback.

How should the asset manager account for the management fee?

Discussion: We believe that revenue from periodic management fees based on assets under management will generally be recognized in a manner that is consistent with current practice. In this case, the real estate asset manager will record revenue each quarter because the services have been utilized by the fund pursuant to the series guidance, the uncertainty regarding the value of the AUM is resolved as of the end of the reporting period, and the fee is not subject to any potential reversal.

Example 2: Performance fees

Facts: A real estate asset manager has a management contract with a fund to provide asset management services. In addition to a base management fee, the manager is entitled to a performance fee equal to 20% of profits generated by the real estate investments in the fund. The management agreement states that the performance fee shall be calculated on the last business day of the calendar year.

How should the real estate asset manager account for the performance fee?

Discussion: The contractual measurement period is based on the terms of the contract and ends on the last business day of the year. To the extent that all or some portion of the performance fees are constrained, the *constrained* revenue will not be recognized in the interim periods (e.g., at the end of each quarter). This determination will require judgment.

Example 3: Carried interest (asset management)

Facts: A real estate asset manager has a contract with a fund to provide asset management services for an annualized fee (paid quarterly) equal to 2% of committed capital. Additionally, the asset manager holds a 1% ownership interest in the fund (structured as a partnership), which provides it with a 1% pro rata share of the fund's profits or losses, as well as an additional capital allocation depending on the performance of the fund. The asset manager will receive the additional 20% capital allocation (the carried interest), which other partners do not receive, when the fund reaches a return of 8% on a cumulative basis over a period as stipulated in the partnership agreement. The asset manager evaluated its ownership interest under ASC 810, *Consolidation*, and determined that the interest results in equity method accounting under ASC 323, *Investments-Equity Method and Joint Ventures*.

[1] The view of the FASB for carried interest can be found in the "Scoping Considerations for Incentive-based Capital Allocations, Such as Carried Interest" paper issued by the Asset Management Transition Resource Group for Revenue Recognition.

How should the asset manager account for the carried interest?

Discussion: It is the FASB's view that the additional capital allocations are fees designed to compensate the manager for services performed and are covered by ASC 606. However, we understand that the SEC staff did not object to the conclusion, in certain asset manager fact patterns, that the partnership investment inclusive of the carried interest could be accounted for in accordance with ASC 323 and, therefore, would not be in the scope of the new revenue guidance. We believe this is only an acceptable alternative if the carried interest is structured as an allocation of profits through a partnership interest. If the carried interest is not structured in this form, we understand the SEC staff would expect ASC 606 to apply. In other words, if the investment manager receives a fee instead of carried interest, the contract to provide asset management services would be subject to ASC 606.

The SEC staff also did not object to the conclusion that the hypothetical liquidation at book value ("HLBV") method would be an acceptable method in applying ASC 323 for the asset manager's pro rata (1%) ownership interest and disproportionate interest (carried interest). However, there will need to be robust disclosures regarding the use of this method. The HLBV method involves assuming that the assets of the fund are distributed to the investors at the reporting date based on their current carrying value. If the fund applies specialized industry guidance, its assets may be reported at fair value. In these cases, the result of applying the HLBV method may be similar to the effects of applying Method 2 in ASC 605-20-S99. We also understand that the SEC staff would object to electing the fair value option on these equity method investments.

The SEC staff did not object to the conclusion that carried interest allocations could be excluded from the income tests for purposes of considering the significance of equity method investments under Regulation S-X Rules 3-09 and 4-08. However, the pro rata distribution rights should be included. These rules determine whether or not the separate financial statements (or summarized financial information) of equity method investees are required to be included in a registrant's filing.

Additionally, the SEC staff did not object, in these circumstances, to the presentation of the results in applying the equity method as operating income (i.e., "above the line") or in a revenue line provided that it was separate from "Revenue from contracts with customers." There should be clear and transparent disclosure of what is reported in the different financial statement line items, particularly in instances when a registrant has carried interest arrangements accounted for under the equity method and other incentive arrangements accounted for under ASC 606. In these instances, it would be important to include an explanation of management's judgments in determining the appropriate accounting model.

Notwithstanding whether the carried interest element is accounted for under the equity method or the new revenue standard, we understand that the SEC staff did not object to the conclusion that, for the purposes of applying the consolidation guidance for variable interest entities, the carried interest element of these arrangements could be viewed as fees paid to the decision makers. As such, it would be possible for these fees not to be considered variable interests under ASC 810.

Many asset managers account for these arrangements under ASC 605-20-S99. While accounting under ASC 606 would be the adoption of a new accounting standard, in order to apply the equity method of accounting under ASC 323 to these instruments, the asset manager would have to change their existing accounting policy. In doing so, registrants should apply the guidance in ASC 250, *Accounting Changes and Error Corrections*, which includes a requirement to restate prior period financial statements. Even if the application of the equity method of accounting and the registrant's current accounting policy do not result in material differences in the amounts reported, there may be a material change to the financial statements with respect to which line item amounts are reported in the income statement and in the related disclosures. The SEC staff stated that preferability letters would not be required for this change.

Example 4: Carried interest (investments in real estate)

Facts: A real estate investment trust (REIT), through a wholly-owned subsidiary that reports on a historical cost US GAAP basis, has a contract with a real estate venture (structured as a partnership) with investments in operating real estate assets to provide property management services for an annualized fee (paid quarterly) equal to 2% of the gross revenues earned by the real estate venture. The REIT is the general partner in the venture with a 25% ownership interest and a pro rata share of the venture's profits and losses. The REIT will receive a 20% capital allocation (the carried interest), which other partners do not receive, when the venture reaches a return of 8% on a cumulative basis over a period stipulated in the partnership agreement. The REIT has evaluated its ownership interest under ASC 810 and determined that the interest results in equity method accounting under ASC 970-323, *Real Estate - General, Investments - Equity Method and Joint Ventures*.

How should the REIT account for the carried interest?

Discussion: The REIT should account for its interest in the venture, inclusive of carried interest, as an equity method investment in accordance with ASC 970-323. The REIT would apply the HLBV method for their pro rata 25% ownership interest and disproportionate interest (the carried interest).

Unlike an asset manager that has historically recognized revenue under Method 1 or Method 2 in accordance with ASC 605-20-S99-1, an entity with an investment in a real estate venture (that is not accounted for on a fair value basis) would have historically accounted for the venture in accordance with ASC 970-323. Upon adoption of the new revenue standard, an entity should continue to account for the investment in the real estate venture as an equity method investment provided it meets all of the following requirements:

- The entity has historically applied the equity method of accounting for their ownership interest, inclusive of the carried interest
- The historical application of the equity method of accounting, inclusive of the carried interest, was and continues to be appropriate
- The carried interest is structured through an asymmetrical allocation of venture capital

Real estate service contracts with more than two parties

Real estate services providers frequently enter into property management, facilities management, project management, and/or other services arrangements with customers. The services in these arrangements are often provided by a number of parties. For example, the service provider may: (1) self-perform portions of the services promised using its own employees, (2) subcontract portions of the services to third-parties, or (3) oversee and manage third-party subcontractors and vendors who have existing contracts directly with the property owner or occupier.

When third-party service providers are used to fulfill promises in a contract with a customer, the reporting entity will need to assess whether the nature of its promise is to provide the services to its customers (i.e., the entity is a principal) or to arrange for the services to be provided by the principal to the end customer (i.e., the entity is the agent). This assessment should be performed for each performance obligation in the arrangement.

Real estate service providers may need to apply significant judgment in determining the performance obligations when there are multiple services promised in an arrangement. Differences in applying this judgment could lead to diversity in gross vs. net presentation of reimbursed third-party costs. If the entire arrangement is deemed to be a single combined performance obligation, the entity should determine if it is acting as a principal or an agent for all of the services provided. This would result in all related employee or third-party costs being presented gross or net. However, if the entity believes that services provided by its own employees are distinct from the services provided by third-party subcontractors, then it may determine that it is acting as a principal for some performance obligations and as an agent for performance obligations provided by third-party subcontractors.

The classification of a principal versus agent hinges on which party obtains control of a specified service before it is transferred to the customer. If the real estate services company obtains control of the third-party's services before they are provided to the end customer, then it is a principal. The updated guidance includes indicators to assist in determining whether an entity controls a specified service before it is transferred to a customer. However, the indicators do not override the assessment of control, should not be viewed in isolation, do not constitute a separate or additional evaluation, and should not be considered a checklist of criteria to be met in all scenarios.

Historically, many real estate service providers often looked to the notion of credit risk and compensation in the form of a commission as factors in assessing whether it was acting as a principal or an agent in an arrangement. "Credit risk" and "consideration in the form of a commission" are not indicators under ASC 606. There are now three indicators of a principal: (1) the entity has responsibility for fulfilling the promise to provide the specified service, (2) the entity obtains or commits to obtain the specified service before obtaining a contract with a customer, and (3) the entity has discretion in establishing the price for the specified service. Reporting entities are required to reassess their historical principal vs. agent conclusions using the new indicators, which could result in a change from historical conclusions.

The amendments are intended to make the guidance more operable and lead to more consistent application. However, they will not eliminate the need for judgment related to principal versus agent assessments.

Example 5: Property management services

Facts: A real estate service provider supplies property management services to a real estate venture for a fee. The service provider's work is partially performed by its own employees and partially performed by subcontractors (e.g., electric work, lawn maintenance). The real estate service provider is not a party to the sub-contractor contracts, as the real estate venture negotiates the pricing and the services with the third-party subcontractors directly. The service provider is also not responsible for the work performed by the subcontractors. It is, however, responsible for the overall management of the property.

With regard to the services provided by the service provider's employees and the third-party subcontractors, is the real estate services provider the principal for the services performed?

Discussion: The real estate service provider is the principal for the services provided by its employees but not for the work provided by the subcontractors, even though the service provider is responsible for the overall property management. The real estate services provider does not have (1) performance risk for the subcontractors' work, as the third party is directly responsible to the real estate venture for its performance, (2) pricing risk, as the price charged by the third-party subcontractors is negotiated by the real estate venture. Therefore the real estate service provider should only recognize revenue and costs in its income statement for the services provided by its employees.

Example 6: General contractor services

Facts: A real estate service provider contracts to be the general contractor (GC) of a new development project for a real estate venture. In return, it is compensated for services through a fixed fee. The GC selects, hires, and oversees/directs the activities of all subcontractors it uses to perform the work; this includes directly negotiating pricing and contracts. In addition, some of the GC's own employees perform the work. The GC takes responsibility for, and guarantees the performance of, its hired subcontractors and employees. If the real estate venture is unsatisfied with the quality of work performed by the subcontractors or GC's employees, GC will be responsible for resolving the quality issues. The GC benefits from any cost savings realized on the job and similarly, guarantees any cost overruns.

With regard to the services provided by the employees of the GC and third-party subcontractors, is the GC the principal for the services provided?

Discussion: The GC is the principal for the services provided by its employees and the subcontractors because it controls the services before the services are provided to the real estate venture. The GC has (1) performance risk, through responsibility for the subcontractors and its employees' performance, (2) inventory risk, through its direct contracting relationship and ability to direct and redirect the subcontractors and employees activities on the development project, and (3) pricing risk, through its ability to set pricing for the project as a whole and its responsibility for cost overruns. Therefore, the fixed fee should be presented in revenue and the costs of the employees and subcontractors should be presented as costs in the income statement.

Tenant construction management

Many real estate entities perform construction management services on behalf of their tenants (e.g., oversight and management of construction of tenant improvements). In these arrangements, the landlord earns fees for performing construction management services for the build out of tenant improvements, which are typically earned over the construction period as the construction management services are performed.

The arrangement qualifies for recognition over time as the customer benefits from the service as it is provided and the landlord, as construction manager, has a right to payment for services provided to date.

Development management

Real estate entities may provide development management services to their customers. The structure of compensation for these services will vary between contracts. For example, one developer may be compensated based on the percentage of completion of the underlying development (using costs incurred), while another could earn its fee based on milestones (e.g., 30% upon the completion of pre-development and 70% upon completion of the development).

Under prior guidance, fees earned by a developer or project manager were often recorded in revenue based on contractual terms (e.g., completion of development or achieving milestones). Under the new standard, the arrangement is required to be recognized over time (i.e., over the development or project period) if the development project receives the benefit of the development services over time, which is often the case. Therefore, the developer must select an attribution method (an input or an output method) that should be used to recognize revenue that is most reflective of the pattern of transfer of services to the customer. A single attribution method should be applied to each distinct performance obligation. While the timing and measurement of revenue recognition for real estate developers utilizing a percentage of completion method under prior guidance would generally remain the same under the new standard, other arrangements may result in a change upon adoption of the new standard.

Leasing commission revenue

Many real estate entities provide leasing brokerage services on behalf of third parties or related parties. In certain scenarios, the associated commission may be earned per the terms of the contract partially at the inception of the lease with the remaining portion earned upon satisfaction of some future contingency. If the broker believes it has substantively satisfied its performance obligation at a point in time (e.g., lease inception) and collection of the second half of the lease commission is probable and not subject to significant reversal, then such amount would be recorded earlier under the new revenue standard.

To illustrate the implications of this change, consider the following example. A real estate entity brokers a third-party leasing arrangement in which the tenant will pay an aggregate of $10 million in rent for an initial period of ten years. The real estate entity receives a commission of $600,000 (6% of $10 million), payable in two installments per the terms of the contract. The first installment (50%) is earned and payable upon successful execution of the lease. The second installment is earned and payable upon tenant move in and payment of the first month's rent. The real estate entity's comparable historical experience supports it is probable the tenant will move in and pay their first month's rent.

Historically, the real estate entity has recorded the commission to revenue based on the contractual earning terms (e.g., 50% upon signing of the lease and 50% upon tenant move in and payment of the first month's rent). Under the new standard, there is likely a single performance obligation that is satisfied when the tenant signs the lease, assuming the broker is not obligated to provide any substantive services subsequent to lease inception. The portion of the transaction price associated with the tenant move in and payment of first month's rent is a form of variable consideration, since the second half of the commission is contingent upon the two events occurring. An estimate of variable consideration is included in the transaction price and recognized as revenue if the entity concludes it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur (i.e., the real estate entity would record the entire $600,000 commission when the tenant signs the lease).

Contract costs

Real estate asset managers should consider if placement fees, capital raise commissions, and other significant upfront transition costs to onboard new customers are costs incurred to obtain or fulfill a contract with a customer and therefore should be capitalized. Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (e.g., sales commissions). Under the new revenue standard, an entity is required to recognize an asset for the incremental costs to obtain a contract that management expects to recover. As a practical expedient, an entity is permitted to expense as incurred the incremental cost of obtaining a contract if the amortization period of the related asset would be one year or less.

An entity recognizes an asset for costs to fulfill a contract when specific criteria are met. Management will first need to evaluate whether the costs incurred to fulfill a contract are in the scope of other standards (e.g., inventory, fixed assets, intangibles). Costs that are in the scope of other standards should be either expensed or capitalized as required by those standards. If fulfillment costs are not in the scope of another standard, an entity recognizes an asset only if all of the following criteria are met: (1) the costs relate directly to a contract, (2) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and (3) the costs are expected to be recovered.

An asset recognized for the costs to obtain or fulfill a contract will be amortized on a systematic basis as control of the goods or services to which the assets relate is transferred to the customer. An entity recognizes an impairment loss to the extent that the carrying amounts of an asset recognized exceeds (1) the amount of consideration the entity expects to receive for the goods or services, less (2) the remaining costs that relate directly to providing those goods or services.

Conclusion

The above discussion does not address all aspects of the revenue standard. Companies should continue to evaluate how the revenue standards might change current business activities, including contract negotiations, key metrics, taxes, budgeting, controls and processes, information technology requirements and accounting. Real estate companies should keep these topics in mind as they complete their implementation of the revenue standards and prepare their initial disclosures. They should also continue to monitor developments and discussions regarding these topics and assess the related impact to their accounting.

Contacts

National Quality Organization

Scott Tornberg
Partner
Phone: (973) 236-5336
Email: scott.w.tornberg@pwc.com

Dusty Stallings
Partner
Phone: (973) 652-6087
Email: dusty.stallings@pwc.com

Jordan Adelson
Senior Manager
Phone: (973) 236-5268
Email: jordan.y.adelson@pwc.com

Logan Redlin
Senior Manager
Phone: (973) 236-5230
Email: logan.redlin@pwc.com

Deals

Julie Schlosky
Director
Phone: (704) 347-1666
Email: julie.m.schlosky@pwc.com

Assurance

Cathy Helmbrecht
US Real Estate Assurance Leader
Phone: (214) 754-7988
Email: cathy.helmbrecht@pwc.com

Justin Frenzel
Senior Manager
Phone: (973) 236-4970
Email: justin.w.frenzel@pwc.com